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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re

REFCO, INC., *et al.,*	No. 05-60006 (rdd)
	Chapter 11
Debtors.	(Jointly administered)

OBJECTION OF THE COMMODITY FUTURES TRADING COMMISSION TO TERMS OF DEBTOR'S PROPOSED SALE OF ITS INTEREST IN REFCO LLC, A REGISTERED FUTURES COMMISSION MERCHANT

The Commodity Futures Trading Commission ("Commission") is an agency of the United States, responsible for regulation of the futures markets and enforcement of the provisions of the Commodity Exchange Act ("CEA"), 7 U.S.C. § 1, *et seq*. The debtor, Refco, Inc., filed its petition under Chapter 11 of the Bankruptcy Code on October 17, 2005. Refco LLC is a non-debtor subsidiary of the debtor; it is registered with the Commission and operates as a futures commission merchant ("FCM") pursuant to CEA Section 4d, 7 U.S.C. § 6d.

On October 21, 2005, the debtor filed a motion for approval of the sale of its interest in Refco LLC and certain other subsidiaries pursuant to Code Section

363(f). The proposed sale is to be effected through a public auction. The debtor filed a Revised Form of Securities Purchase Agreement ("Purchase Agreement") on October 26, 2005, and this Court entered a bidding procedures Order the same day.

SUMMARY OF THE COMMISSION'S CONCERNS

> From the Commission's perspective, Refco LLC is a solvent FCM that is conducting regular business operations. The Commission does not oppose a sale of Refco LLC, if, in the business judgment of the relevant parties, such a sale is appropriate.
>
> The Commission objects to any individual term of sale that would require that Refco LLC and its officers be insulated from liability for any past wrongdoing. While we do not intend to suggest anything negative about the conduct of the firm, no person or company is above the law. The commercial sale of a business cannot be premised on a grant of immunity from ordinary law enforcement.
>
> The Commission also objects to any term that would compromise the legal protections the Commodity Exchange Act provides to customers that entrust their funds to a futures commission merchant. Any customer that proves that it provided funds "to margin" or "guarantee" or "secure" its trades with the futures commission merchant is entitled to the statutory protection of its funds.

ARGUMENT

I. The Proposal to Use the Bankruptcy Power to Prevent Regulatory and Law Enforcement Actions against a Non-Debtor FCM and its Officers and Agents is Fundamentally Flawed

The debtor's proposal in the Purchase Agreement provides for an injunction against any investigation or law enforcement action against the FCM entity, and certain individuals, "arising out" of or "related to" or "resulting from" an excluded or "channeled" claim, whether actions for monetary relief or other sanctions. See Purchase Agreement at 3 (definition of "Channeled Claim" and "Channeling

Injunction"), at 6 (definition of "Excluded Liabilities"), and at 10 (definition of "Proceeding.").

The type of claims covered by these provisions of the Purchase Agreement could include claims for unauthorized trading, embezzlement or theft of funds or property. These CEA offenses could lead to criminal or civil sanctions against the culpable actors. *See, e.g.*, CEA Sections 6(c), 6c, 9(a)(1), and 13(a), 7 U.S.C. §§ 9, 13a-1, 13(a)(1), 13c(a). Moreover, a finding of violation of these provisions, whether in a civil or criminal proceeding, is a statutory disqualification from registration of under the CEA. *See* CEA Sections 8a(2)-(4) and 9(b), 7 U.S.C. §§12a(2)-(4) and 13(b). At its starkest, debtor's proposed Purchase Agreement seeks immunities and exculpations from this Court that not even the President may grant under the Article II Pardon Power. *See Hirschberg v. Commodity Futures Trading Commission,* 414 F.3d 679, 683 (7th Cir. 2005).

The proposed channeling injunction even purports to bar certain Congressional investigations.[1] The Commission doubts that such a bar, or even the lesser bar against agency investigations, is constitutionally defensible or consistent with any purpose of the Bankruptcy Code. *See Watkins v. United States,* 354 U.S. 178, 187 (1957) (the power to conduct investigations is inherent in the legislative process); *Board of Governors v. MCorp. Financial, Inc.*, 502 U.S. 32, 40 (1991) (Under Code Section 362(b)(4) bankruptcy court scrutiny of the validity of every

[1] The definition of "Governmental Entity" includes "any… (iii) body exercising…legislative authority or power of any nature…." Purchase Agreement at 7.

administrative or enforcement action "is problematic" because it is "inconsistent with the limited authority Congress has vested in bankruptcy courts.") This Court should reject out of hand any attempt to have it issue orders purporting to grant any type of law enforcement immunity to any person or entity.[2]

II. The Congressional Requirements under the CEA and the Bankruptcy Code for Customer Protection and Protection of the Markets are Ignored under the Provisions of the Current Proposal

In the CEA, Congress has established a comprehensive scheme designed to protect the integrity and efficient functioning of commodity futures markets and to safeguard the funds of futures customers.

With respect to customer funds, *see e.g.,* Section 4d(2) of the CEA, 7 U.S.C. § 6d(2) (requiring an FCM separately to account for each customer's funds, and prohibiting commingling with the FCM's funds or using one customer's funds to margin the trading of another customer); 17 C.F.R. 1.20-28, 1.32.(establishing detailed requirements for segregation and maintenance of customer funds). The obligation of an FCM to treat and deal with customer funds as "belonging to [the] customer" is a paramount principle in the statutory scheme. *See* 7 U.S.C. § 6d(2). Where a customer fails to continuously meet its margin requirements, the FCM must use its own capital to make up the deficit, so as to avoid permitting the use of

[2] This Court should not become "a haven for wrongdoers." *CFTC v. Co Petro Marketing Group, Inc.*, 700 F.2d 1279, 1283 (9th Cir. 1983); *see SEC v. Brennan,* 230 F.3d 65, 71 (2d Cir. 2000) (debtor should be prevented from "frustrating necessary governmental functions by seeking refuge in bankruptcy").

one customer's funds to margin the trading of another. *See* 17 C.F.R. 1.22; 63 Fed. Reg. 2188, 2190 (Jan. 14, 1998).

Section 4f(b) of the CEA, 7 U.S.C. § 6f(b), requires each FCM to continuously meet "such minimum financial requirements as the Commission may by regulation prescribe as necessary to insure his meeting his obligations as a registrant." The Commission requires an FCM to give prompt "early warning" notice to the Commission and its designated self-regulatory organization if the FCM's capital declines a specified extent since its last monthly report, or declines below certain points. *See* 17 C.F.R. 1.12.

The purpose of the capital requirements is to ensure that each FCM reliably maintains sufficient liquid capital to meet its obligation as a financial intermediary promptly, and in the ordinary course of business. Capital is an essential line of defense supporting the FCM's ability to meet its obligations – both liquidated and unliquidated – to customers as well as to other financial institutions, such as clearing organizations. The FCM's ability to meet its web of obligations continuously is crucial to the financial integrity of futures markets. *See Capital Options Investments, Inc. v. Goldberg Bros. Commodities, Inc.*, 958 F.2d 186, 190 (7th Cir. 1992.)

Current information suggests that Refco LLC meets, and in fact exceeds, all capital and customer funds requirements. Bankruptcy court intervention into the affairs of a non-bankrupt FCM, as part of the reorganization of its parent, disrupts

the regulatory scheme and will adversely affect the relationship between the FCM and its counterparties.[3]

Congress already has addressed these specific issues under the Bankruptcy Code. Thus, Code Section 103(d) provides that Subchapter IV of Chapter 7 applies in the case of commodity brokers. The term, "commodity broker" is defined by 11 U.S.C. § 101(6) to include futures commission merchants, such as Refco LLC. Moreover, Code Section 109(d), which prohibits reorganization of an FCM, makes Subchapter IV the exclusive vehicle for dealing with the liabilities and market integrity issues of an FCM under the Code. Accordingly, the Code itself prohibits bankruptcy court intervention in the business of an FCM unless the FCM is in a case under Subchapter IV.[4]

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[3] Section 4f of the CEA also provides for the Commission to establish minimum financial requirements for introducing brokers ("IBs"). 7 U.S.C. § 6f. These financial requirements are designed to promote an IB's ability to meet its obligations, including unliquidated obligations, to customers. *See* H.R. Conf. Rep. No. 97-964 at 4 (1982). In implementing this requirement, the Commission has established specific requirements, *see* 17 C.F.R. 1.17(a)(1)(iii), but permitted IBs to meet their financial requirements by obtaining a guarantee from a qualified FCM (such IBs are referred to as "GIBs"). As indicated in its most recent financial filing with the Commission, Refco LLC provides guarantees for more than one hundred GIB's. Permitting a solvent FCM to disclaim its pre-sale guarantee obligations for these IBs for the benefit of its corporate parent undermines the regulatory scheme. *See First American Discount, Corp. v. CFTC,* 222 F.3d 1008, 1016-1018 (D.C. Cir. 2000).

[4] The Commission notes that certain terms of the proposed Purchase Agreement appear to be formally inconsistent with the basic requirements of Code Section 363(f). The Commission also urges that this Court's authority to enter a channeling injunction at all is limited by Code Section 524(g), and this matter does not satisfy the requirements of that Section.

CONCLUSION

In the Commission's view neither the regulatory concerns discussed above nor the Code itself, need be a bar to the exercise by the parent of business judgment with respect to the future of its subsidiary, so long as the business resolution comports with the regulatory and statutory constraints.

Respectfully submitted,

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